General Services Administration
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Ms. Donna Searcy, Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, DC 20554

Subject: Simplification of the Depreciation Process
CC Docket No. 92-296

Dear Ms. Searcy:

Enclosed please find the original and nine copies of the General Services Administration's Comments for filing in the above-referenced docket.

Sincerely,

Michael J. Ettner

Michael J. Ettner
Senior Assistant General Counsel
Personal Property Division

Enclosures

cc: International Transcription Service
Accounting and Audits Division

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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
Simplification of the Depreciation	)	CC Docket No. 92-296
Prescription Process	)	

COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

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March 10, 1993

SUMMARY

In these Comments, GSA offers a recommended resolution to each of six decisional issues that are raised by the Commission's NPRM of December 29, 1993. First, GSA strongly disagrees with the assertion that the price cap plan allows relaxation of Commission scrutiny over depreciation. Depreciation continues to affect the allowable rate levels of any LEC earning a return outside the 10.25 to 12.25 percent no–sharing zone. Second, the Commission should prescribe depreciation parameters, not depreciation rates, because rate prescription would obliterate the advantages of the remaining life and equal life group procedures. Third, the Commission should require the respective RBOCs to file depreciation rate applications on a total company basis unless they can justify subregional or state–specific rates. Fourth, the Commission should prescribe specific factors rather than ranges of factors, because the designation of ranges is itself a contentious and judgmental process. Fifth, the Commission should abandon three–way meetings as a mechanism for developing depreciation parameters and adopt instead notice and comment procedures. Finally, the Commission should exclude net salvage from depreciation, as the present salvage ratios procedure is inherently inaccurate.

While these conclusions lead to the rejection of all four of the Commission's proposed options, they do allow for significant simplification (1) by allowing carriers to file on a Companywide or multi–state basis, (2) by eliminating three–way meetings, and (3) by excluding net salvage from the depreciation process.

COMMENTS OF THE GENERAL SERVICE ADMINISTRATION

CC DOCKET NO. 92-296

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FEDERAL COMMUNICATIONS COMMISSION
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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of Simplification of the Depreciation Prescription Process	)	CC Docket No. 92–296

COMMENTS OF THE GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA"), on behalf of the Federal Executive Agencies, hereby submits its Comments in response to the Commission's Notice of Proposed Rulemaking ("NPRM"), FCC 92–537, released December 29, 1992 in CC Docket No. 92–296. This NPRM solicits comments and replies on the simplification of the depreciation prescription process.

I. INTRODUCTION

The NPRM asserts that because of institution of the price cap plan and because of the alleged high cost to the carriers of depreciation analysis, it is appropriate to determine whether the present detailed represcription process is necessary.[1] The Commission proposes four options for simplifying the determination of depreciation expense.[2]

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1 NPRM, para. 8.

2 NPRM, para. 9–12.

1. To establish a range of basic factors—future net salvage, projection life and survivor curves—for each account within which the carriers would be allowed to select factors for each property account.

2. To establish a range of depreciation rates for each account within which the carriers could select their respective rates.

3. To specify the service life, retirement pattern and salvage value for each account.

4. To allow price cap carriers to file depreciation rates with no supporting data.

In the discussion that follows, GSA addresses six decisional issues that are raised by the NPRM and which cut across the options proposed by the Commission. GSA's comments will demonstrate that, while some simplification of the represcription process is feasible and desirable, none of the four options proposed in the NPRM is appropriate.

II. DECISIONAL ISSUES

1. Whether to Relax the Regulation of Depreciation.

In para. 8 of the NPRM, the Commission makes the following statements:

> Our price cap plan encourages carrier efficiency without allowing them to pass depreciation expense changes onto ratepayers.(ftn) Thus, the scrutiny necessary under rate of return/rate base regulation may be relaxed under price cap regulation.
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> ---
>
> (ftn) We note that because price cap carriers would generally not be able to pass along depreciation expense changes, higher depreciation expense can lead to lower earnings for those carriers.

GSA strongly disagrees with these assertions. At best, they apply only to AT&T, and even for that carrier a case could be made that they are not altogether accurate. With respect to the Local Exchange Carriers ("LECs"), the Commission has prescribed a "sharing and adjustment mechanism" which allows rate level modifications based on earned rate of return to be superimposed upon the price cap controls. Furthermore, all carriers, including AT&T, have a constitutional right to apply for rate increases if their revenue recovery falls below their costs, including return on capital invested, as recognized in the regulatory accounting mechanism.[3] Since that regulatory accounting mechanism includes depreciation, it is inaccurate to say, as the FCC does, that depreciation increases can no longer be passed through to ratepayers. Clearly, if a carrier is experiencing revenue deficiency, that revenue deficiency is increased, dollar for dollar, to the extent that depreciation expense is increased.

On the upside, the Commission has implemented a sharing mechanism when price cap regulated LECs enjoy rates of return in excess of a range established by the Commission, currently 10.25 to 12.25 percent.[4] Since depreciation is probably the largest single expense of any telephone company, an increase in depreciation can effectively obliterate any appearance of excess earnings and so avoid the need to share those excess earnings with ratepayers.

On the foregoing basis, GSA strongly objects to the Commission's conclusion that it no longer needs to regulate depreciation, particularly for the Local Exchange Carriers. At best, an argument could be made for deregulating AT&T's depreciation rates, not because of price caps, but because AT&T is now a competitive enterprise, the earnings of which are more controlled by the market than by the Commission's regulation.[5]

None of the above suggests, however, that it is inappropriate for the Commission to consider possible simplification of the depreciation rate prescription

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3 Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 692–693 (1923). Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944). The Commission has recognized the right of regulated companies to earn an adequate return by allowing price cap regulated LECs that are experiencing deficient earnings to increase rates to the lower end of the no–sharing zone, currently 10.25 percent. Second Report and Order, CC Docket No. 87–313, October 4, 1990, para. 127.

4 Second Report and Order, paras. 123 and 127.

5 AT&T has made exactly this argument in its petition of January 27, 1993 to permit it to use its financial reporting depreciation rates as the basis for regulatory reporting. GSA takes no position on AT&T's petition at this time.

process. To the contrary, considerable simplification is both feasible and desirable That simplification should not, however, be based on the proposition that the Commission no longer needs to regulate depreciation rates.

2. Whether to Prescribe Depreciation Rates or the Underlying Depreciation Factors.

In its first and second options, the Commission poses the choice of prescribing either depreciation rates or, alternatively, the underlying factors, that is, projection lives, survivor curves and salvage ratios. Much of the discussion in the NPRM suggests that the Commission already finds problems with the prospect of prescribing depreciation rates. The Commission recognizes correctly that such a prescription obliterates the advantages of remaining life depreciation because it does not permit rate adjustments to reflect the current deficiency or excess of the depreciation reserve in specific accounts of individual companies.[6] Particularly when an obsolescent category of plant is being phased out, the ability to make radical adjustments in the depreciation rate may be the only way to ensure full recovery of capital and to avoid a permanent reserve excess or deficiency.

There are other reasons as well for retaining the present procedure of prescribing depreciation parameters rather than rates. The average age of the plant or, more specifically, the mix of vintages may differ from company to company, even when the life characteristics of the account are identical. With equal life group depreciation, this different vintage mix can lead to significantly different depreciation rates. Thus, a focus on rates rather than underlying parameters effectively destroys the presumptive refinement and precision of the equal life group depreciation mechanism.

Finally, it is not depreciation rates that are studied in the underlying analyses, but rather the parameters that dictate those rates. No one studies, for example, the

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[6] NPRM, para. 31.

depreciation rate for motor vehicles. Rather, they analyze the service life, the retirement dispersion and the salvage experience of those vehicles. The depreciation rate is merely derivative. Since the parameters determine the rate, it is relevant to examine the parameters, not the rate.

3. Whether to Apply Depreciation Rates Nationwide, by Company, or by State.

Arguably, it is hard to rationalize why a DMS200 switching office in Virginia would have any different life characteristics than a DMS200 switching office in California. The same would apply to buildings, vehicles, computers, furniture and office equipment. Even outside plant, which is affected by climate, is much more influenced by technology, which is essentially non–geographic. Presumably, these considerations underlie Commission Option 3, which is to provide nationwide depreciation parameters for each category of plant.

GSA submits that it is inappropriate to impute to every telephone company the average practice of all telephone companies. A principal determinant of service life is the tradeoff between maintenance and replacement. The management of one company may decide to minimize its capital outlays by increasing maintenance and modifying technology to achieve a longer life for its existing plant rather than replacing it with new technology. Another company may prefer replacement over life extension. This is particularly relevant as the company strategies for engaging in unregulated activities may differ widely across the country.

On the other hand, it is hard to understand why the service life for BellSouth's central office investment in, say, South Carolina, necessarily differs from that in Georgia, particularly as the focus of FCC prescription is on interstate communications, not local telephone service. If BellSouth adopts a maintenance and replacement philosophy in one state, it is likely to apply that philosophy throughout its service territory. These considerations suggest that depreciation prescription should be on a

Regional Bell Operating Company ("RBOC") basis except where the Company demonstrates that there are state-specific or possibly subregion-specific factors (such as climate or rate of growth) that justify depreciation rates specific to areas smaller than the total RBOC service territory.[7] Even then, the subregions do not necessarily have to conform to states. Indeed, they might apply to rural vs. urban areas, or they might apply to groups of states.

The advantage to the FCC is fairly obvious. Rather than 33 separate applications, which in turn are broken down by state, the FCC would entertain seven regional Bell applications and possibly three or four GTE applications. The remaining companies subject to represcription might file on a nationwide or regional basis at their choosing. This procedure has the obvious advantage of reducing the number and bulk of the applications without necessarily diminishing their precision. To the contrary, the greater "thickness" of the underlying data might improve the precision of the historical analyses, particularly when applied to some of the smaller accounts.

4. Whether to Prescribe a Range or Specific Factors.

The NPRM implies a preference for prescribing a range of factors (Option 1) or rates (Option 2) rather than specific factors (Option 3) on the grounds that somehow the use of ranges would simplify the regulatory process. GSA questions whether this will be the result. It would appear that the requirement to specify a range simply adds one more layer of decision making to the represcription process, i.e., the decision as to how broad the range should be.

Certainly the prescription of ranges rather than specific factors would not improve the precision of the resultant depreciation rates. The actual effect is quite obvious. It would increase the discretion of the LECs to select depreciation factors, hence depreciation rates, that best suit their financial objectives, including the

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7 The prescription of RBOC depreciation rates would be consistant with the current practice of filing RBOC access tariffs.

objective of avoiding excess earnings subject to sharing or the objective of creating an appearance of earnings deficiency such as might justify a rate increase beyond the price cap limit. For this reason, GSA urges the Commission to continue to prescribe specific depreciation factors, that is, projection lives and survivor curves.[8]

5. Whether to Simplify the Represcription Procedure.

In paragraph 42 of the NPRM, the Commission suggests that under its Option 4, where the Commission would avoid prescribing depreciation rates or parameters for price cap carriers, the three–way meetings would no longer occur. The implication is that they would continue to occur under the other three options. GSA submits that the usefulness of the three–way meetings has been exhausted, not because the requirement to regulate depreciation rates no longer exists, but because the Supreme Court's 1986 decision in Louisiana P.S.C.[9] has decoupled the prescription of interstate depreciation rates from that of intrastate rates. Prior to the Louisiana decision, it was desirable for the state and federal regulators to agree to depreciation parameters because ultimately only one set of parameters would be prescribed for both interstate and intrastate purposes. This condition no longer exists. In many three–way meetings, the state representatives attend merely as observers because the represcription of intrastate parameters is the subject of a separate proceeding before the state commission. Three–way meetings are expensive, cumbersome, and sometimes indecisive. Not insignificant from GSA's standpoint, they exclude all other parties aside from the two commissions and, on occasion, the state consumer advocate agency.[10]

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8 For reasons discussed herein (Issue 6), the Commission should refrain from prescribing salvage ratios.

9 Louisiana Public Service Commission v. Federal Communications Commission 476 U.S. 355, 106 S.Ct. 1890, 90 L.Ed.2d 369 (1986).

10 While the results of the three–way meetings are open to public comment, they are effectively faits accomplis by the time the public has the opportunity to comment. GSA is aware of no instance in which unanimous conclusions of three–way meetings were later modified as a result of public comment.

A far more effective, streamlined and relevant procedure for prescribing interstate depreciation rates would be the notice and comment mechanism that the Commission uses for most of its other decision making. Under this procedure, the carriers would distribute their depreciation proposals and underlying studies to all interested parties, and those parties would file comments pursuant to a schedule prescribed by the Commission. Following a round of reply comments, the Commission could then reach its decision based on the written record before it. There would be no necessity for meetings, and all parties, not just the state commissions, would have an opportunity for input into the decisional process.

6. Whether Salvage should be Expensed or Capitalized.

Somewhat as an aside, the Commission, in paragraph 43, suggests the possibility of expensing net salvage and eliminating it from the depreciation process. GSA strongly supports this proposal. The propriety of the present salvage ratio procedure is highly questionable, particularly when there are very large costs of removal.

Under existing procedures, the net salvage allowance for each account is derived from a salvage ratio. The salvage ratio is the result of a fraction, the numerator of which is the net of recent experience in positive salvage less cost of removal, expressed in current dollars, and the denominator of which is the original cost of plant recently retired. This ratio is then applied to the total original investment value of the plant currently in service.

Clearly, the original cost of 20–year old retired plant in the denominator is expressed in dollars of much greater value than those in the numerator. The ratio is therefore overstated simply by reason of the change in the value of the dollar. The net salvage allowance is further overstated when it is applied to the book value of the entire account expressed in dollars having yet a different value.

The result of this procedure is a consistent overrecovery of net salvage allowances relative to current salvage experience, particularly for very long–lived plant accounts, such as poles and cables, that experience high net costs of removal. The assessed charges for cost of removal that are buried in the depreciation rates for these accounts far exceed the actual annual removal costs incurred. The present procedure ensures that this overrecovery of removal costs will continue indefinitely so long as current dollars are less valuable, per dollar, than embedded investment dollars, and so long as the plant accounts continue to grow.

GSA therefore strongly supports the Commission's proposal to exclude salvage (and cost of removal) from the depreciation process. The proposal has conceptual merit quite apparent from the obvious simplification in carrier accounting and depreciation rate represcription.

Generally Accepted Accounting Principles (GAAP) requires that "(t)he method of depreciation chosen must result in the systematic and rational allocation of the cost of the asset (less its residual value) over the asset's expected useful life."[11] While "residual value" implies salvage value, there is no mention of negative salvage, that is, cost of removal. Negative salvage is included in depreciation more by analogy or symmetry with positive salvage than as the result of any statement of GAAP by such authorities as the Financial Accounting Standards Board.

Certainly implicit in GAAP is the requirement that the estimate of salvage, whether positive or negative, should be accurate. GSA submits that the salvage ratio methodology currently used by the Commission does not fulfill this threshold requirement for accuracy. As noted, it is based on ratios of net salvage dollars to investment dollars that reflect different time periods, hence different values of the dollar. Those ratios are then applied to plant–in–service dollars, reflecting a still

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[11] Interpretation and Application of Generally Accepted Accounting Principles, 1993, Delaney, Adler, Epstein and Faron, John Wiley & Sons, p. 231.

different mix of dollar values. GSA submits that the current salvage methodology is utterly incapable of ensuring the accurate recognition of net salvage effects. Such inaccuracy is hardly consistent with GAAP.

GSA is not alone in its views. In Penn Sheraton v. Pennsylvania Public Utility Commission,[12] the Superior Court of Pennsylvania ruled that projected negative net salvage could not be included within depreciation expense when rates were set. The Court held as follows:

> Negative salvage attributed to existing plant is purely prospective; it is a cost which has not yet been incurred; it is uncertain when and if it will be incurred; and it is not a part of the original cost of construction of the facilities when first devoted to public service. To permit the recovery of prospective negative salvage is to permit the recovery of a total amount in excess of the original cost of construction prior to the actual expenditure of those costs ....
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> • • •
>
> Although prospective negative salvage is not entitled to consideration, the negative salvage actually incurred by the utility ... is of course entitled to consideration in a rate proceeding. It is then no longer prospective but actual.[13]

GSA submits that the only way to ensure that actual net salvage—no more and no less—is charged to the ratepayer revenue requirement is to recognize it as a current expense or revenue as it is experienced.

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[12] 198 Pa.Super. 618, 184 A.2d 324 (1962).

[13] Id. at 627–628, 184 A.2d at 329.

III. CONCLUSION

As the agency vested with the responsibility for acquiring telecommunications services for use of the Federal Executive Agencies, GSA supports the Commission's efforts to simplify the depreciation represcription process. It cannot, however, support any of the four simplification options proposed in the NPRM.

Option 1 must be rejected because it contemplates the establishment of ranges of depreciation parameters, which will likely prove to be more complex and judgmental than the present procedure of setting specific parameters for each carrier.

Option 2 must be rejected because it, too, calls for establishing ranges, but also because it deals with rates, rather than parameters, and thereby undercuts the remaining life and equal life group procedures previously adopted by the Commission.

Option 3 must be rejected because it does not allow for legitimate differences among carriers as regards operational and investment practices, rates of system growth, and technological orientation.

Option 4 must be rejected because it falsely assumes that there is no longer any need to regulate the depreciation of price cap carriers. Depreciation continues to play an important role in the rate level determination of price cap LECs. Arguably, it is not as relevant for AT&T.

While the options proposed in the NPRM are unsuitable as framed, there are important steps the Commission could take to simplify its depreciation prescription process. First, each RBOC should file for a single set of depreciation rates unless it can demonstrate that state or subregional aggregations are more appropriate. Second, the Commission should abandon the three–way meeting process for setting depreciation parameters and adopt the same notice and comment procedure as it uses in most of its contested proceedings. Finally, the Commission should exclude net salvage from the depreciation process.

Respectfully submitted,

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Due: March 10, 1993

CERTIFICATE OF SERVICE

I, Michael J. Ettner, do hereby certify that copies of the foregoing "Comments of the General Services Administration" were served this 8 th day of March 1993, by postage paid or hand delivery (indicated below by asterisks) to the following parties:

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